The Changing Tobacco User's Dollar

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Abstract: Consumers increased their total spending on tobacco products about 1.3 times from 1991 to 1998. About 93 percent of expenditures were for cigarettes, and these expenditures advanced because price hikes offset declining consumption. The proportion of expenditures on cigarettes declined slightly, mostly due to higher expenditures on cigars. Wholesale cigarette prices have jumped 29 percent since 1991. Excise taxes have increased 27 percent. The farmer's share of the tobacco user's dollar declined from 1991 to 1998 because domestic cigarette consumption fell and use of imported tobacco increased. The manufacturer's share shrunk while the wholesaler-retailer share advanced. The excise tax share rose slightly. Despite continued reductions in consumption, consumer expenditures are likely to rise in the coming years as prices increase.

Keywords: Tobacco expenditures, tobacco user's dollar, cigarette prices, cigarette consumption, excise taxes, and tobacco products.

Expenditures on tobacco products in the United States trended upward for many years, reaching a record high $57.3 billion in 1998. Higher cigarette prices and increasing State excise taxes have offset declining cigarette consumption, boosting total expenditures (table B-1). These expenditures comprised .95 percent of consumer disposable income and about 1.7 times the amount spent on tobacco products in 1990. About 93 percent of expenditures were for cigarettes, 2.8 percent for cigars, and 4.2 for other tobacco products (smoking tobacco, chewing tobacco, and snuff).

During the 1920's, cigarettes emerged as the leading form of tobacco consumption, and by the mid-fifties and early sixties accounted for 85 to 90 percent of expenditures on tobacco products. Rising expenditures on cigarettes during the last decade reflect rising prices and taxes. After peaking at 640 billion in 1981, consumption declined steadily to 465 billion cigarettes in 1998. This decline occurred despite increases in both the smoking age population and disposable income. Consumption declined further in 1999.

Retail prices for cigarettes increased sharply over the last decade primarily because of rising wholesale prices. However, increases in Federal, State, and local excise taxes also contributed to the increase. Wholesale prices of branded filter-tipped cigarettes (excluding excise taxes) have more than doubled since January 1990. During the early and mid-1990's, consumers shifted to generic cigarette brands in the face of rising prices. However, in August 1993, cigarette manufacturers lowered wholesale prices for premium cigarettes and have been steadily regaining market share since.

Tobacco Taxes

In 1998, excise taxes represented 26 percent of consumer expenditures on tobacco products, slightly higher than in 1991. Although State excise tax collections increased due to higher rates, Federal collections fell as consumption declined. State tax collections have exceeded Federal collections since 1986, notwithstanding Federal tax increases of 4 cents per pack (of 20 cigarettes) in 1991 and 1993. In fiscal year 1998, tobacco accounted for .3 percent of total Federal tax receipts and represented 42 percent of all Federal excise tax collections. Federal excise taxes totaled $5.6 billion in calendar 1998, compared with $4.6 in 1991. Since 1991, with two increases in the Federal excise tax, and numerous increases by State and local jurisdictions, Federal excise taxes as a proportion of total expenditures on tobacco products declined. State and local taxes rose to $8.0 billion, up from $6.2 billion in 1991, while total excise tax collections rose from $10.0 to $13.6 billion. About 98 to 99 percent of tobacco tax revenue is from cigarettes. However, Federal excise tax applies to cigars, snuff, chewing tobacco, and pipe smoking tobacco. Forty-four States tax both cigarettes and other tobacco products, compared with 35 in 1991.

Iowa imposed the first cigarette tax in 1921. By 1950, 40 States and the District of Columbia taxed cigarettes, and by 1970, all 50 States taxed them. Taxes currently range from 2.5 cents per pack in Virginia to $1.00 per pack in Alaska and Hawaii. State cigarette excise taxes, weighted by sales, averaged 34.75 cents per pack as of July 1998. Currently,

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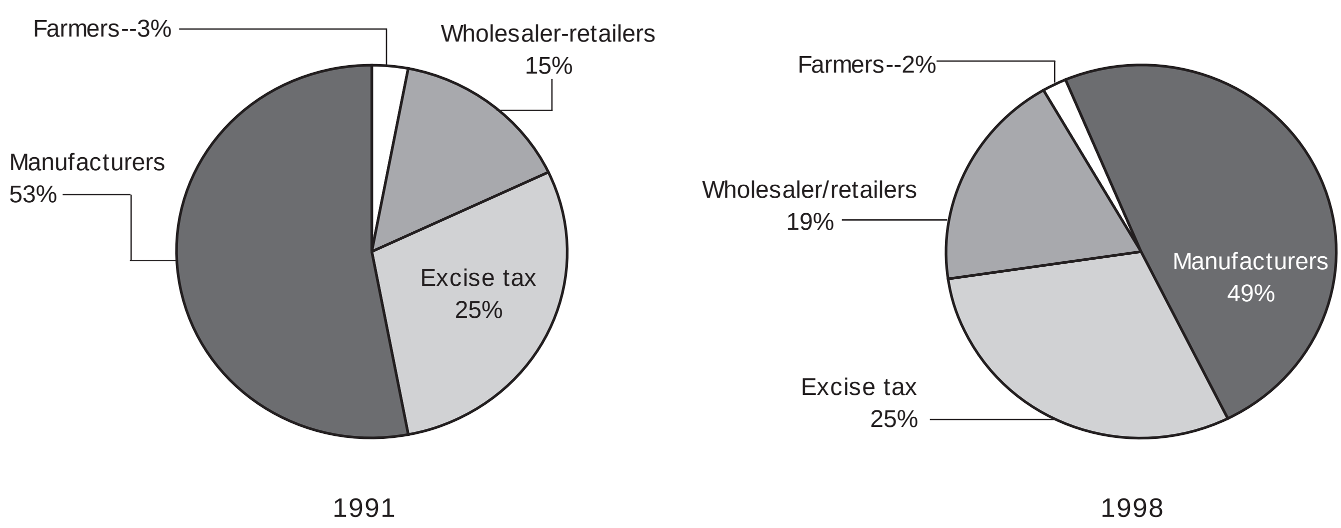
Figure B-1
Cigarette user's dollar



Total may not add due to rounding.

Table B-1--Expenditures for tobacco products and disposable personal income, 1989-98 1/

Year	Total	Cigarettes	Cigars 2/	Other 3/	Disposable personal income	Percent of disposable personal income spent on tobacco products: All	Cigarettes	Cigars 2/	Other 3/
	Million dollars				Billion dollars	Percent			
1989	39,675	37,400	675	1,600	3,789	1.05	0.99	0.02	0.04
1990	41,920	39,500	695	1,725	4,051	1.04	0.98	0.02	0.04
1991	45,305	42,850	705	1,840	4,231	1.08	1.02	0.02	0.04
1992	48,470	45,790	715	1,965	4,500	1.08	1.02	0.02	0.04
1993	48,955	46,150	730	2,075	4,789	1.04	0.98	0.02	0.04
1994	47,297	44,544	766	1,987	5,022	0.96	0.90	0.02	0.04
1995	48,692	45,793	846	2,053	5,356	0.92	0.86	0.02	0.04
1996	50,363	47,233	1,012	2,118	5,535	0.90	0.85	0.02	0.04
1997 4/	52,167	48,734	1,229	2,205	5,795	0.90	0.84	0.02	0.04
1998 5/	57,273	53,236	1,607	2,430	6,027	0.95	0.88	0.03	0.04

1/ Expenditures exclude sales tax. 2/ Includes small cigars (cigarette-size). 3/ Smoking tobacco, chewing tobacco, and snuff. 4/ Subject to revision. 5/ Estimated.
Compiled from reports of Department of Commerce, Bureau of Economic Analysis.

Table B-2--Total expenditures, farm value, and marketing bill for cigarettes, U.S., 1990-98

Year	Consumer expenditures	Farm value less exports	Marketing Bill: Manu-facturing 1/	Marketing Bill: Wholesaling-retailing	Marketing Bill: Total	Excise Taxes: Total	Excise Taxes: Federal	Excise Taxes: State and local	Sales taxes	Total taxes
	Million dollars									
1990	39,500	1,360	21,294	6,714	28,008	9,992	4,206	5,786	1,500	11,492
1991	42,850	1,075	22,810	6,552	29,363	10,707	4,551	6,156	1,706	12,413
1992	45,790	1,155	25,678	5,373	31,051	11,511	5,185	6,326	2,073	13,584
1993	46,150	970	25,082	6,065	31,148	12,023	5,563	6,460	2,009	14,032
1994	44,544	1,190	20,170	8,107	28,277	13,062	5,977	7,085	2,016	15,078
1995	45,793	1,074	20,695	8,724	29,419	13,300	5,892	7,407	2,000	15,300
1996	47,233	1,248	21,373	9,214	30,587	13,385	5,913	7,472	2,013	15,398
1997	48,734	1,123	23,013	9,160	32,173	13,435	5,839	7,597	2,003	15,438
1998	53,236	1,053	26,184	10,255	36,439	13,563	5,580	7,983	2,181	15,744
	Percent of consumer expenditures									
1990		3	54	17	71	25	11	15	4	29
1991		3	53	15	69	25	11	14	4	29
1992		3	56	12	68	25	11	14	5	30
1993		2	54	13	67	26	12	14	4	30
1994		3	45	18	63	29	13	16	5	34
1995		2	45	19	64	29	13	16	4	33
1996		3	45	20	65	28	13	16	4	33
1997		2	47	19	66	28	12	16	4	32
1998		2	49	19	68	25	10	15	4	30

1/ Estimated by multipling average wholesale price less taxes by taxable removals.

the weighted average State excise tax rate is 34.19 cents. Nineteen States and the District of Columbia currently have tax rates over 40 cents per pack.

The Federal excise tax remained at 8 cents a pack from 1951 until it was doubled on January 1, 1983. From 1983 to 1986, Federal tax collections exceeded State taxes as they did during the 1950’s. Since 1986, State collections have exceeded Federal revenues from tobacco. The Federal excise tax is scheduled to increase to 34 cents per pack of 20 cigarettes on January 1, 2000, and will increase another 5 cents per pack in 2002.

The Tobacco Dollar

While tobacco manufacturers and distributors shared in the increase in spending on tobacco products from 1991 to 1998, farmers received less. In 1991 U.S. growers received 4 cents of the consumer tobacco dollar. In 1998, they received 2 cents. In contrast, manufacturers and wholesalers-retailers received 69 cents in 1991, and about the same in 1998. The distributor's share totaled 15 percent in 1991 and increased to 19 percent in 1998. Excise taxes took 25 cents of the consumer's dollar in 1998, the same as 1991, and 34 cents in 1980. The Federal tax share remained unchanged from 1991 at 11 percent in 1998. State and local taxes increased to 15 percent in 1998, up from 14.4 percent in 1991.

The farm value of domestic tobacco used in cigarettes sold in the United States was $1.05 billion, 2 percent below 1991. Although farm prices increased, fewer cigarettes were sold in the United States, and the domestic leaf use per cigarette declined, as imported leaf displaced some U.S.-grown leaf. Wholesale cigarette prices increased 1,500 percent since 1950, and rose about 13 percent since 1991. Average farm prices have risen only 5.5 cents per pound since 1991. The average retail price of a pack of cigarettes rose from $1.53 to $1.95 during the same period.

Cigarette Marketing Bill

The U.S. marketing bill for cigarettes totaled $10.3 billion in 1998, compared with $6.6 billion in 1991. It represented about 68 percent of consumer spending on cigarettes in both years (table B-2). The marketing bill is comprised of manufacturing and distribution costs. It is the difference between farm value and consumer expenditures for cigarettes, less excise tax. During 1991-98, the manufacturer’s share of consumer spending on cigarettes slipped from 53 to 49 percent. In contrast the wholesaler-retailer portion increased from 15 to 19 percent. The manufacturing bill includes charges for assembling, stemming, redrying, storing, aging, and converting tobacco (including foreign-grown tobacco) to cigarettes, and distributing them to wholesalers and retailers.

Cigarette excise taxes are included in the retail price. The excise tax portion of expenditures has advanced slightly during the last decade with the State and local tax share rising more than the Federal share.

Taxes and Prices Will Continue To Advance During the Next Decade

Spending on tobacco products likely will continue to rise during the first decade of the next century. The effects of the November 1998 settlement will continue to be felt by cigarette consumers in the form of higher prices. The possibility of a major increase in the Federal excise tax remains.

Manufacturers face continued falling domestic volume and export demand, and wholesale prices will be forced up by settlement costs and the need for profits. Tax rates of State and local governments will continue to rise, but perhaps not as quickly as during the nineties. During the next decade, income of cigarette manufacturers is likely to grow due to the inelastic nature of cigarette demand. As cigarette prices increase, demand will fall by a lesser proportion. Taxes are likely to increase, but whether their share of consumer expenditures on tobacco products or cigarettes will change is uncertain.

During the coming decade, changes in how leaf tobacco is marketed, the Federal tobacco program, and dependence on imported tobacco are likely to affect the farm share of the cigarette user’s dollar.

Contracting in Tobacco?

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Abstract: Philip Morris surprised the tobacco community this year by issuing a press release stating that it was considering offering tobacco growers production contracts. Major questions currently raised by the tobacco community center on what impacts contracting would have on growers, consumers, and the tobacco program. While this article cannot answer all the questions, it provides some structure for a discussion of contracting. The article defines different kinds of agricultural contracts, provides an economic explanation for selling and producing agricultural commodities under contract, and discusses the experience of contracting in two industries: broilers and grains.

Keywords: Contracting, tobacco, production, and marketing contracts.

In a surprising press release earlier this year, Philip Morris stated its intention to begin contracting directly with U.S. tobacco farmers. Currently, of the major foreign producers, only Brazilian tobacco is grown under contract. In the United States, most tobacco is sold through a government-sanctioned auction, so this proposed action would dramatically alter the way tobacco is grown and marketed in the United States. The release created a stir as many wondered about the impact of contracting on the U.S. tobacco industry. Farmers questioned whether their profits would decline. Health advocates speculated that tobacco prices might fall and increase tobacco consumption. And everyone wondered if it would be possible for the tobacco program to remain intact if Philip Morris began contract production.

Contracts, while new to tobacco growers, are widely used in the production and sale of many agricultural commodities. For example, broilers, hogs, and cattle are produced under contract, some grain is produced under contract, vegetables for processing are generally produced under contract, and fresh fruits and vegetables are sometimes sold under contract. Specialized products—such as organic vegetables intended for processing, or a particular variety of wheat needed for pasta—are often produced under contract. The experience of the past suggests that contracts are here to stay and are likely to be used more frequently over time.

Many researchers believe that consumer preferences are driving the proliferation of agricultural contracts, in particular, production contracts. The rationale underlying this belief is that consumers have developed stronger preferences for specific qualities (Drabenstott). In response, manufacturers and other intermediaries have begun directly contracting with growers to ensure that they receive exactly the quality and quantity desired. For example, cigarette production requires a particular blend of different tobaccos, specifically "narrowly defined grades and styles of flue-cured and burley tobacco to produce very flavor-specific blends for our high quality cigarettes" (Philip Morris). In this light, the Philip Morris announcement is not surprising, since one proven way for manufacturers to get inputs of a desired quality is by writing production contracts with growers.

Producers and consumer advocates often question the value of producing agricultural commodities under contract, particularly during the period that an industry is transitioning from spot market sales to production contracting. Frequently raised questions include: Will only large producers have access to production contracts? What happens to growers who do not produce under contract? What impact does production contracting have on rural communities? Are contracts fair to producers? Admittedly, this paper does not answer all of these questions. We try, however, to provide some context for contracting by first presenting a general overview of the use of contracts in agriculture. We next try to provide insight into the costs and benefits of producing under contract by examining contracts in two industries, grains and broilers.[2]

[1] The authors are an economist with the Economic Research Service, USDA and an Assistant Professor at the University of Tennessee, respectively.

[2] Neil Hamilton, in his article "Why Own the Farm If You Can Own the Farmer (and the Crop)?: Contract Production and Intellectual Property Protection of Grain Crops," has completed an extensive legal/economic analysis of grain production contracts. Steve Martinez, in the ERS report "Vertical Coordination in the Pork and Broiler Industries: Implications for Pork and Chicken Products" has done a similarly impressive job with broilers. We rely on these two reports for much of our factual information about the form of grain and broiler contracts.